No. 12,973

In the United States Court of Appeals for the Ninth Circuit

SHAFFER TERMINALS, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

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INDEX

	Page
Opinion Below	1
Jurisdiction	1
Question Presented	2
Statute and Regulations Involved	2
Statement	3
Summary of Argument	8
Argument:	
The so-called "rental" payments here involved did not qualify as deductible business expenses under the statute	9
Conclusion	26

CITATIONS

Cases:

Armston v. *Commissioner,* 12 T.C. 539	14
Armston, W. H., Co. v. *Commissioner,* 188 F. 2d 531	8, 9
Bazley v. *Commissioner,* 331 U. S. 737	10
Brown v. *Commissioner,* 180 F. 2d 926	23
Commissioner v. *Court Holding Co.,* 324 U. S. 331	10
Commissioner v. *Culbertson,* 337 U. S. 733	22
Commissioner v. *Greenspun,* 156 F. 2d 917	9, 23
Commissioner v. *Sunnen,* 333 U. S. 591	14
Commissioner v. *Tower,* 327 U. S. 280	10
Deputy v. *du Pont,* 308 U. S. 488	9
Gregory v. *Helvering,* 293 U. S. 465	10
Griffiths v. *Commissioner,* 308 U. S. 355	10
Helvering v. *Clifford,* 309 U. S. 331	14
Higgins v. *Smith,* 308 U. S. 473	10, 20
Illinois Agricultural Hold. Co. v. *Commissioner,* 131 F. 2d 583	9, 25
Ingle Coal Corp. v. *Commissioner,* 174 F. 2d 569	9
Interstate Transit Lines v. *Commissioner,* 319 U. S. 590	9
Limericks, Inc. v. *Commissioner,* 165 F. 2d 483	9
Minnesota Tea Co. v. *Helvering,* 302 U. S. 609	10
New Colonial Co. v. *Helvering,* 292 U. S. 435	9
Paramount-Richards Th. v. *Commissioner,* 153 F. 2d 602	9
Rand v. *Helvering,* 77 F. 2d 450	16
Regensburg v. *Commissioner,* 144 F. 2d 41, certiorari denied, 323 U. S. 783	9
Skemp v. *Commissioner,* 168 F. 2d 598	23
Twin Oaks Co. v. *Commissioner,* 183 F. 2d 385	24

Statute:

Internal Revenue Code, Sec. 23 (26 U.S.C. 1946 ed., Sec. 23)	2

Miscellaneous:

Treasury Regulations 111, Sec. 29.23(a)-1	3

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OPINION BELOW

The findings of fact and opinion of the Tax Court (R. 172-190) are reported at 16 T.C. 356.

JURISDICTION

The petition for review (R. 191-193), which was filed May 9, 1951 (R. 193), and involves deficiencies in excess profits tax of $20,537.77 and $22,220.52 for the years 1944 and 1945, respectively. On September 23, 1949, the Commissioner of Internal Revenue mailed to the taxpayer notice of a deficiency in the total amount of $42,758.29. (R. 9-15.) Within ninety days thereafter and on December 12, 1949, the taxpayer filed a petition

with the Tax Court for a redetermination of that deficiency under the provisions of Section 272 of the Internal Revenue Code. (R. 5-15.) The decision of the Tax Court sustaining the deficiency was entered February 19, 1951. (R. 191.) The case is brought to this Court by a petition for review filed May 9, 1951 (R. 191-193), pursuant to Section 1141(a) of the Internal Revenue Code, as amended by Section 36 of the Act of June 25, 1948.

QUESTION PRESENTED

Whether so-called "rental" payments made by taxpayer corporation to a partnership composed of taxpayer's sole stockholders were deductible as "ordinary and necessary" business expenses under Section 23(a)(1)(A) of the Internal Revenue Code.

STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code:

SEC. 23 [As amended by Sec. 121 of the Revenue Act of 1942, c. 619, 56 Stat. 798]. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) *Expenses.*—

(1) *Trade or business expenses.*—

(A) *In general.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to

which the taxpayer has not taken or is not taking title or in which he has no equity.

* * * * *

(26 U.S.C. 1946 ed., Sec. 23.)

Treasury Regulations 111, promulgated under the Internal Revenue Code:

> Sec. 29.23(a)-1. *Business Expenses.*—Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business * * *. * * * Among the items included in business expenses are management expenses * * * and rental for the use of business property. * * *

STATEMENT

The facts as stipulated (R. 18-26) and found by the Tax Court (R. 172-184) may be summarized as follows:

Taxpayer is a corporation engaged in the business of operating warehouse terminals and storage in Tacoma, Washington. On October 20, 1943, R. H. Shaffer, one of taxpayer's four shareholders, died. His shares of stock in taxpayer were acquired by the surviving shareholders. (R. 172.) On December 31, 1943, the capital stock of taxpayer was held as follows (R. 173):

Shareholder	Shares	% of Ownership
Samuel B. Stocking [president]	157	78.5
K. M. Kennell [vice-president-secretary]	26	13
W. Hopkins [treasurer]	17	8.5
[Total]	200	100

The business of taxpayer increased very rapidly and continuously from July 1942 through 1943 and the subsequent war years. This increase was due to war business provided by the United States Army and Navy, the Russian Government and the British Government.

Taxpayer handled various cargoes for these contractors on a daily basis, under an arrangement with the named governments, which was expected to and did continue for the duration of the war. (R. 173.)

Early in 1943, due to the increase in business and the increasing pressure from the army for the return of rented equipment, it became apparent to the officers of taxpayer that additional equipment, such as clark-fork type lift trucks, should be acquired, and the officers of taxpayer began considering the feasibility of purchasing new equipment. Informal discussions were had with E. E. Searles, vice president of the Puget Sound National Bank, concerning the purchase of equipment and the possibility of obtaining a loan for this purpose. No formal loan application was made by taxpayer for consideration by the loan committee of the bank. This equipment was essential war material and could not be acquired except on priority. Taxpayer could obtain the priority because of its essential war activities. Taxpayer applied for and was granted priority to purchase new equipment in April 1943. (R. 173, 174, 182.)

On September 22, 1943, a partnership was organized by the four original stockholders of taxpayer under the style of Equipment Associates (sometimes hereinafter referred to as the partnership). Subsequent to the death of R. H. Shaffer on October 20, 1943, decedent's interest was acquired equally by the surviving partners and the business was conducted as a partnership under the same name. The partnership agreement stated that the purpose and business of the copartnership was primarily to furnish certain equipment, such as dock tractors, lift trucks, etc., for the exclusive use of Shaffer Terminals, Inc., in essential war work, which equipment was to be leased by the partnership to taxpayer. The agreement further provided that, when not being

used by taxpayer, and with its consent, the equipment could be temporarily leased to others. (R. 174-175.)

The capital invested in Equipment Associates consisted solely of cash furnished in equal mounts by the partners. Each partner contributed $2,500. The investment made by W. Hopkins was from his personal funds. Investments made by the other partners were in part from personal funds and in part from bank loans. (R. 175.)

The affairs of Equipment Associates were managed by Samuel B. Stocking, for which he was paid $200 per month, and its books of account were kept by E. A. Seaton, for which he was paid $30 per month, both items being deductions before partners' distribution of earnings. E. A. Seaton was also the regular bookkeeper for taxpayer. Equipment Associates employed no other employees. It used the office of taxpayer for which no rent or charge was paid. Taxpayer and Equipment Associates kept separate books and records and there was no intermingling of the partnership and corporate funds or records. The partnership owned no other property except the terminal equipment leased to taxpayer. (R. 175-176.)

Subsequent to September 22, 1943, and at all times here material, taxpayer obtained the necessary priorities and purchased equipment similar to that already described above. The partnership did not apply for priorities. Taxpayer made these purchases on September 30, 1943, March 21, 1944, and June 16, 1945, for the respective sums of $9,529.44, $10,298.60, and $10.319.61. After each purchase, taxpayer transferred legal title to the equipment to the partnership, pursuant to certain "Sale and Lease Agreements" executed in October 1943, in March 1944, and in June 1945, and received the partnership's checks in payment either before or within

a month after taxpayer's check in payment of the equipment had cleared. (R. 176-177.)

The first purchase of equipment by the partnership was paid for out of the original contributions of capital made by the partners. The second and third purchases were financed by separate loans obtained from the Puget Sound National Bank of Tacoma, upon the basis of chattel mortgages and the increased earnings of the partnership. These loans were classified as commercial or short term, and notes therefor were drawn on terms of 90 days. (R. 177, 183.)

All of the sale and lease agreements were substantially similar in terms to the "Sale and Lease Agreement" executed October 8, 1943, differing only as to date and the amount of the sales value of the equipment. The "Sale and Lease Agreement" executed October 8, 1943, provides in part that taxpayer had sold and transferred the equipment which it had purchased to Equipment Associates for the sum of $9,529.44. (R. 177-178.)

Under the "Sale and Lease Agreement" taxpayer reserved the exclusive right to lease the equipment from Equipment Associates during the entire time of the emergency created by the war. (R. 178.)

In the event Equipment Associates determined to dispose of any of the equipment, taxpayer was given the first right to purchase the equipment at a price to be agreed upon by the parties to the agreement. (R. 178.)

The rentals paid by taxpayer to the partnership were in accord with Tacoma Terminal Tariffs filed with the Public Service Commission of the State of Washington in compliance with Section 10383 of Remington's Revised Statutes of Washington. The amounts paid in 1944 and 1945 respectively were $41,134.82 and $29,434.46. The total amount paid in rentals for the equipment from 1943 to 1947 was $90,144.10. (R. 179-180.)

During the period here involved—1944 and 1945—no dividends were declard by taxpayer. Prior to this period the last dividend was in 1942, and the first dividend after this period was in January 1946, in the amount of $12,000. (R. 180.)

A summary of taxpayer's working capital position at the end of the tax years, and on or about the dates when the equipment was acquired shows that on or about each of the dates on which equipment was purchased, taxpayer's cash balance exceeded the cost of the equipment by a substantial margin. Taxpayer's earned surplus on December 31, 1944, and December 31, 1945, was $67,-303. 28 and $68,922.29, respectively. (R. 180-182.)

The Puget Sound National Bank had made loans to taxpayer during the years from 1930 to 1941 when taxpayer's record was not too satisfactory. During the years 1942 to 1945 taxpayer's financial statements showed additional strength and the size of the loans was increased. These loans were usually made for short terms upon assignment to the bank of accounts receivable and were primarily used to meet current expenses. (R. 182.)

The gross profits of the partnership, as shown by its income tax returns for 1944, 1945 and 1946, were $41,468.32, $30,568.07, and $11,725.32, respectively. From January 1 to June 30, 1947, the date on which the partnership was dissolved, its gross profit was $912.72. (R. 183.)

On April 23, 1947, the partnership transferred part of the equipment covered by the "Sale and Lease Agreements" back to taxpayer for the sum of $10,-613.49, the book value of the equipment, plus sales tax of $318.40. The remaining equipment was distributed in final liquidation on June 30, 1947, to the individual partners who transferred it to taxpayer on October 27, 1947, for a total consideration of $7,500. The book

value, or depreciated value of this equipment was $7,223.73 on December 31, 1946. (R. 183.)

Taxpayer's profits were such that it already was in the 90 per cent bracket under the excess profits tax, and no substantial benefit would have resulted from taxpayer acquiring the necessary equipment. The stockholders of taxpayer organized the partnership, primarily to avoid the excess profits tax and its impact on the earnings of taxpayer. It was not organized for the purpose of financing the purchase of equipment which taxpayer needed in its business. (R. 184.)

SUMMARY OF ARGUMENT

Under the facts here, the Tax Court correctly found that the sale-lease arrangement between the corporation and its majority stockholder was not in substance what it appeared to be in form and accordingly that it has no effect for tax purposes. The corporation's full control over, and right to use, the equipment sold to the partnership whose members owned all of the stock of the corporation, was not altered in any respect by the transfer of title. The alleged business reason for the arrangement, to provide the corporation with additional working capital, was not, and could not have been achieved, since the corporation's obligation to pay rentals for the equipment allegedly sold effectively removed the amount received as the "sale" price from the partnership from availability as working capital. Since the alleged business reason was nonexistent, the only other purpose for the arrangement suggested by the record was to create "rentals" which would form the basis for a tax deduction and thus reduce the corporation's income and excess profits taxes commencing in 1943. Because the arrangement was nothing but a tax-avoidance device, with no business purpose, it is to be disregarded for tax purposes, under the principle stated in *W. H.*

Armston Co. v. *Commissioner,* 188 F. 2d 531, and *Commissioner* v. *Greenspun,* 156 F. 2d 917, 920. Each case turns on its own facts, and other cases, having factual differences, consequently cannot control in this case.

ARGUMENT

The So-called "Rental" Payments Here Involved Did Not Qualify as Deductible Business Expenses Under the Statute

This case involves the question of whether the so-called "rental" payments made by taxpayer corporation to a partnership composed of its sole stockholders were deductible under Section 23(a)(1)(A) of the Internal Revenue Code, *supra.* That section authorizes the deduction from gross income of:

> All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including * * * rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

Needless to say, so-called "expenses" are often in reality dividend distributions or some other form of non-deductible payments, and the burden is on the taxpayer to prove that claimed deductions are allowable. *Interstate Transit Lines* v. *Commissioner,* 319 U.S. 590; *Deputy* v. *duPont,* 308 U.S. 488; *New Colonial Ice Co.* v. *Helvering,* 292 U.S. 435; *Ingle Coal Corp.* v. *Commissioner,* 174 F. 2d 569 (C.A. 7th); *Limericks, Inc.* v. *Commissioner,* 165 F. 2d 483 (C.A. 5th); *W. H. Armston Co.* v. *Commissioner,* 188 F. 2d 531 (C.A. 5th); *Illinois Agricultural Hold. Co.* v. *Commissioner,* 131 F. 2d 583 (C.A. 7th); *Paramount-Richards Th.* v. *Commissioner,* 153 F. 2d 602, 604 (C.A. 5th); *Regensburg* v. *Commissioner,* 144 F. 2d 41 (C.A. 2d), certiorari

denied, 323 U.S. 783. Moreover, "The mere fact that the expense was incurred under contractual obligation does not, * * * make it the equivalent of a rightful deduction under Section 23(a)". *Interstate Transit Lines* v. *Commissioner, supra,* p. 594.

It is axiomatic that tax consequences flow from the substance of a transaction rather than its form, and that transactions between a corporation and its controlling stockholders are subject to special scrutiny. *Commissioner* v. *Court Holding Co.,* 324 U.S. 331; *Gregory* v. *Helvering,* 293 U.S. 465; *Higgins* v. *Smith,* 308 U.S. 473; *Minnesota Tea Co.* v. *Helvering,* 302 U.S. 609; *Griffiths* v. *Commissioner,* 308 U.S. 355; *Bazley* v. *Commissioner,* 331 U.S. 737; *Commissioner* v. *Tower,* 327 U.S. 280. It may be noted preliminarily that the "rental" payments here involved admittedly were made to taxpayer's stockholders (R. 184), were made during years when taxpayer's business was increasing very rapidly, when the excess profits tax was in effect, and when taxpayer was in the 90% bracket.

The critical facts are not in dispute. Taxpayer corporation, having need for heavy dock equipment, its sole stockholders formed a partnership, for the purpose, as stated in the partnership agreement, of purchasing the necessary equipment and renting it to taxpayer. The capital invested in the partnership consisted solely of cash furnished equally by the partners, in the total amount of $10,000,[1] most of which was obtained by the partners on short term (90-day) bank loans. (R. 23, 177.) This original invested capital was used to finance the first purchase of equipment, and two subsequent purchases were financed by bank loans to the partner-

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[1] The original contributions were $2,500 each from Messrs. Shaffer, Stocking, Kennell and Hopkins. Upon the death of Mr. Shaffer in October, 1943, the remaining three partners purchased his interest in equal shares.

ship, based upon the increased earnings of the partnership. The loans were secured by chattel mortgages on the equipment. The total purchase price of all the equipment amounted to $30,147.65. The equipment could not be acquired except on priorities, which were obtained, not by the partnership, but by taxpayer. As to each of the three separate purchases of equipment which were made, taxpayer ordered the equipment *and paid for it.* After each purchase taxpayer transferred legal title to the equipment to the partnership, pursuant to certain "Sale and Lease Agreements", and was reimbursed the amount of the purchase price by the partnership. Upon the acquisition by the partnership of the legal title to the equipment, taxpayer "rented" the equipment from the partnership, paying some $90,000 in "rentals" between October, 1943 and June, 1947, when the partnership was liquidated and dissolved.[2] Just prior to its dissolution the partnership sold part of the equipment to taxpayer for $10,613.49, plus a sales tax. Upon dissolution the remaining equipment was distributed to the partners who sold it to taxpayer for $7,500. (R. 183.)

The deductibility of the "rental" payments thus depends upon whether the series of transactions comprising the formation of the partnership and the "Sale and Lease Agreements" were in substance what they appeared to be in form. Only if they were, can they be effective for tax purposes. *W. H. Armston Co.* v. *Commissioner, supra, Ingle Coal Corp.* v. *Commissioner, supra.*

The Tax Court found that the partnership was not organized by taxpayer's stockholders for the purpose of financing the purchase of the equipment, but was organized "primarily to avoid the excess profits tax

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[2] The amount of so-called "rentals" here in issue is $70,569.28—the payments made in 1944 and 1945. (R. 180.)

and its impact on the earnings of petitioner" (R. 184), and that finding compelled the conclusion reached by the Tax Court (R. 189) that:

> * * * this entire plan is not, in substance, a sale and lease transaction recognizable for tax purposes and we therefore hold that the amounts paid the partnership by petitioner are not deductible as rent under section 23(a)(1)(A) of the Code.

It is submitted that this ultimate factual conclusion (*Limericks, Inc.* v. *Commissioner, supra*), far from being clearly erroneous, is fully supported by the record. A brief resume of the provisions of the agreements and the surrounding circumstances will suffice to show that none of the transactions here involved served any real business purpose for the taxpayer, but that, on the contrary, taxpayer remained in the same position with respect to the equipment as if none of the transactions had taken place.

Since the parties involved were taxpayer and its sole stockholders, the same persons controlled the policies of both the "lessor" and the "lessee". Those persons had it within their power to alter the agreements or release either of the parties thereto at any time. (R. 115.) Moreover, even under the terms of the agreements, taxpayer at all times retained complete control over the equipment which it had supposedly "sold" to the partnership. The agreements gave to the partnership only the bare legal title. Thus the "partnership agreement" provided that the purpose and business of the partnership was to hold the equipment for the exclusive use of Shaffer Terminals. (R. 27.) It further provided that the equipment could be leased to others only "when not being used" by taxpayer, and then only with its consent and approval. (R. 27.) The "Sale and Lease" agreements reserved to taxpayer the "exclusive right" to use the equipment (R. 30), and granted tax-

payer "first right to purchase" it in the event the partnership should determine to sell (R. 31). There is among these conditions, no indication of the unconditional and irrevocable conveyance of the property which is necessary in order to constitute a true sale. On the contrary, as taxpayer's own witness admitted (R. 115) the partnership was never "free to dispose of the equipment or use the equipment in any way", and it is patent that the transfer to the partnership would not have occurred except upon the condition that the "lease" back to taxpayer of the equipment would simultaneously follow. The "Sale" and "Lease", contained in the same instrument, were obviously interdependent and conditional upon each other, and the Tax Court recognized this when it said (R. 187-188):

> The net effect of the agreement was to strip the partnership of all incidents of ownership, vesting in it only bare legal title while control over the property remained in petitioner. Such a reservation of control contradicts a sale which presupposes that the seller loses not only title but control. *Esperson* v. *Commissioner* (C.A., 5th Cir.), 49 Fed. (2d) 259); *Schoenberg* v. *Commissioner* (C.A., 8th Cir.), 77 Fed. (2d) 446. Such command over the property marks petitioner as the real owner for income tax purposes. *Commissioner* v. *Court Holding Co.,* 324 U.S. 331.

A matter of the utmost significance is the fact that the partnership was formed shortly after taxpayer's business had experienced a very rapid increase (R. 99) which had the effect of placing taxpayer in the 90% bracket under the excess profits tax; and the partnership was dissolved in 1947, after the repeal of the excess profits tax, at which time legal title to the equipment was reconveyed to taxpayer (R. 25-26, 183). It was stipulated (R. 24) that, before deciding to organize the partnership, the stockholders considered the fact that

taxpayer was in the 90% bracket. It is thus clear that the partnership was created for a limited purpose and was never regarded as a permanent organization. From the very beginning, it was contemplated that it would not be necessary for any partner to devote any appreciable time to the business of the partnership. (R. 113.) The partnership had no office except the office of taxpayer, and it hired no employee except a bookkeeper who was actually the regular bookkeeper for taxpayer. (R. 123.) In short, the partnership was never really intended to be more than a holder of legal title to the equipment used by taxpayer in its business. To be sure, it had transferred title to the equipment, but in the circumstances it was only a bare legal title, with all the effective rights of ownership retained by the corporation. Cf. *Helvering* v. *Clifford,* 309 U.S. 331; *Commissioner* v. *Sunnen,* 333 U. S. 591, 607-610.

Superimposed upon all of these circumstances is the highly important fact that during the years involved taxpayer discontinued payment of its dividends. (R. 23.)

It is apparent upon analysis of all the facts that the present case is, in all essential respects, indistinguishable from *Armston* v. *Commissioner,* 12 T.C. 539, affirmed, 188 F. 2d 531 (C.A. 5th). In that case the taxpayer was a corporation engaged principally in the construction business. In the taxable years, roughly 39% of its outstanding stock was owned by W. H. Armston, 60% by his wife, Catherine G. Armston, and 1% by K. W. Kerr. In 1943, taxpayer sold its construction equipment, which was essential to the operation of its business, to Catherine G. Armston for approximately $30,000, the price being determined by the taxpayer's book value as of February 1, 1943. Catherine G. Armston had to borrow the amount of the purchase price in order to finance the transaction. Simultaneously with

the sale, Catherine G. Armston leased back the equipment to taxpayer at a "rental" equal to prevailing comparable rentals. As pointed out by the Tax Court (R. 189) the facts here are even stronger than those presented in the *Armston* case, since there the lessor possessed control over the use of the equipment and full right of sale, whereas here no such right existed. Taxpayer argued, as taxpayer does in the instant case, that it sold the equipment in order to obtain needed working capital, because (188 F. 2d 531, 532):

> * * * it was not good business for the company to have substantially all of its capital and surplus tied up in heavy fixed equipment when funds were needed for the payment of current debts and capital was required for payrolls * * *

There, as here, no dividends were paid by taxpayer during the taxable years, but, in the *Armston* case, taxpayer paid "rentals" totaling over $167,000 for the three years involved. The Court of Appeals for the Fifth Circuit, in affirming the Tax Court's decision that the "rentals" were not deductible, said (p. 533):

> The evidence here conclusively reveals that the Company's right to use the equipment supposedly sold to Catherine Armston was in no wise affected by the alleged transfer of title. The only logical motive and purpose of the arrangement under consideration was the creation of "rentals", which would form the basis for a substantial tax deduction, and thereby reduce the Company's income and excess profits taxes from the year 1943. It was merely a device for minimizing tax liability, with no legitimate business purpose, and must therefore be disregarded for tax purposes. [citing cases]

It is submitted that the finding of the Tax Court (R. 184) that the partnership was organized "primarily to avoid the excess profits tax and its impact on the earnings of petitioners" was equally justified here. Tax-

payer's contention (Br. 24-25) that such finding constitutes error because "directly contrary to the testimony of the said K. M. Kennell" is without merit. The Tax Court was not bound to believe or accept the testimony of Mr. Kennell, even if uncontradicted. Under such circumstances, the testimony of interested parties may properly be regarded as "insufficient to carry the burden of proof resting on the taxpayers." *Rand* v. *Helvering,* 77 F. 2d 450, 451 (C. A. 8th). This is especially true where the undisputed facts give rise to inferences which support the trial court's decision.

Moreover, Mr. Kennell's testimony that taxpayer's finances were not sufficient to justify its purchase of the equipment will not bear analysis. On the contrary, the record clearly demonstrates that the purchase of the equipment was warranted by taxpayer's financial condition. Taxpayer had ample working capital to pay for the equipment on each of the purchase dates, and *actually did* make such payments. As a matter of fact, on the dates of each of the first two purchases, taxpayer's cash on hand totaled approximately three times the amount of the purchase price, and on the date of the last purchase, its cash on hand totaled six times the purchase price. On September 30, 1943, when the partnership was organized and the first purchase of equipment, costing $9,500 was made, taxpayer had over $28,000 in cash and approximately $135,000 in accounts receivable. On each of the purchase dates, taxpayer's receivables exceeded its payables by a very substantial margin. This firm financial condition existed not only on the dates on which the purchases were made, but prevailed all during the period from the first purchase on September 30, 1943, through the third purchase on June 16, 1945. (R. 181.) Moreover, taxpayer's accounts receivable were, in the main, accounts of the United States Army and Navy, and the British and Russian

governments. Taxpayer could thus anticipate that a very high percentage of them would be paid, and such was actually the case. For example, taxpayer grossed over $490,000 in 1944 (R. 38) and over $390,000 in 1945 (R. 56), yet of these amounts, only 16.4% remained unpaid and on the books as accounts receivable at the end of 1944 (R. 41), while less than 9% remained unpaid at the end of 1945 (R. 59). In short, as the Tax Court observed (R. 185), "petitioner's working capital position at the time of the various purchases * * * was ample to cover checks drawn on its account". This is all the more apparent when it is considered that within the first four months after the first purchase of equipment taxpayer had paid "rentals" totaling just $354 less than the entire cost of that purchase; that nine months after the first purchase the "rentals" paid equalled the cost of the first and second purchases, and that eleven months after the first purchase taxpayer had paid the partnership an amount equal to the cost of all three purchases of equipment. (R. 33.) Thus, some seven months before the second purchase of equipment, and twenty-one and one-half months before the third purchase, taxpayer had paid "rentals" equal to the entire cost of the equipment. (R. 33-34.) The total amount of the "rentals" paid from the date of the first purchase to the dissolution of the partnership in June, 1947, totaled some $90,000, or approximately three times the total purchase price. Moreover, taxpayer eventually repurchased the equipment at a cost of over $18,000. Thus, taxpayer had paid over $108,000 for equipment originally costing $30,000. (R. 189.) How then can it seriously be contended that such expenditures are deductible as "ordinary and necessary" business expenses?

Taxpayer has failed to prove even that there was any necessity for financing the equipment through a loan,

much less through the very expensive method of "renting" it from the partnership. Assuming, however, that it had been necessary to borrow money for the purchase of the equipment, taxpayer has likewise failed to sustain its contention that it could not have obtained a loan, as did its stockholders in 1943, and the partnership in 1944 and 1945. Taxpayer sought to show that it would not have qualified for such a loan through the deposition of E. E. Searles, vice-president of the bank where both taxpayer and the partnership banked. (R. 131.) It is firmly established that taxpayer did not apply for such a loan, and hence whether it would or would not have qualified at Searles' bank is clearly beside the point. Assuming, however, that Searles' testimony was material to a determination of the issue presented in this case, it was testimony of an interested witness—an officer of taxpayer's bank—who was making an obvious effort to substantiate taxpayer's contention. The finding of the Tax Court that Searles' testimony "although contradictory, is to the effect that petitioner would have been granted a short-term loan had it made application" (R. 186) is the subject of taxpayer's assignment of error No. 6 (Br. 11). The record, however, is very clear that Searles testified exactly as the Tax Court found. After being confronted with the fact that the bank had approved many short-term loans to taxpayer in years prior to 1941, when "the company never had a very good record" (R. 135); and that it had approved short-term loans to taxpayer in amounts from $2,000 to $10,000 between 1941 and 1943 (R. 145-148), and that such loans had been paid by taxpayer (R. 148), Searles qualified his testimony as follows (R. 149):

> Q. So when you said you discouraged borrowing by Shaffer Terminals when you were discussing this matter with Mr. Stocking, you meant borrowing on a basis of eighteen months or one year?
> A. That is right.

Q. And when you said Shaffer Terminals was not qualified to borrow, say $9500.00 in September of 1943, you meant borrowing upon a long term?

A. That would be my opinion on it, that is correct.

While it is true that after admitting taxpayer would have qualified for a short-term loan, Searles did continue to maintain that it would not have qualified for a long-term loan, it is manifest that that distinction is without significance where the test here was whether taxpayer would have fared as well as the stockholders and the partnership, who, after all, applied for and received short-term loans. (R. 177.) Certainly there can exist no valid reason for discriminating in favor of the partnership or taxpayer's stockholders, especially when it is realized that the purpose of the loans was to finance the purchase of equipment needed and to be used by taxpayer in its business; that the source of the repayment of the loans was taxpayer's income (R. 165-166); and that at the time of the forming of the partnership taxpayer's cash balance (exclusive of its large accounts receivable) totaled some three times the cash balance of the partnership (R. 107, 172, 174, 175).

We believe taxpayer's assignment of error No. 7 (Br. 11)—that the Tax Court erred in holding that the partnership was a subservient agency from which independence and control had been stripped (R. 190)—has been adequately disposed of by our previous discussion of the control which was retained by taxpayer over the partnership's actions, and the patently limited purpose of the partnership. However, even assuming *arguendo* that taxpayer and the partnership were completely separate entities, as taxpayer contends (Br. 13), that fact alone would not constitute the "rental" payments deductible expenses, since "the Government may not be

required to acquiesce in the taxpayer's election of that form for doing business which is most advantageous to him." *Higgins* v. *Smith,* 308 U.S. 473, 477. In this respect the present case is analogous to the *Higgins* case where the question of whether a taxpayer was entitled to deduct as a loss the difference between the cost of certain securities and the sale price at which taxpayer had sold the securities to a corporation wholly owned by taxpayer. There it was clear that an actual corporation existed. Numerous transactions were carried on by it over a period of years. It paid taxes, state and national, franchise and income. But, as the Supreme Court said (p. 476):

> * * * the existence of an actual corporation is only one incident necessary to complete an actual sale to it under the revenue act. Title, we shall assume, passed to Innisfail [the corporation] but the taxpayer retained the control. Through the corporate forms he might manipulate as he chose the exercise of shareholder's rights in the various corporations, issuers of the securities, and command the disposition of the securities themselves. There is not enough of substance in such a sale finally to determine a loss.

So here the record clearly supports the Tax Court's conclusion (R. 189) that:

> Upon close scrutiny, this entire plan is not, in substance, a sale and lease transaction recognizable for tax purposes * * *.

Certainly apart from the subservience of the partnership to the corporation, on the undisputed facts, the taxpayer can hardly sustain the burden of proving that the expenditures were ordinary and necessary.

Taxpayer's contention that the "Sale and Lease Agreements" should be recognized taxwise because they changed "the flow of economic benefits effected by these

transactions" (Br. 21) is without merit. Preliminarily, it is submitted that taxpayer's analysis of *Higgins* v. *Smith, supra,* (Br. 19-20) is not warranted. There the Supreme Court, in discussing *Gregory* v. *Helvering, supra,* stated (p. 476):

> If, * * * the *Gregory* case is viewed as a precedent for the disregard of a transfer of assets without a business purpose but solely to reduce tax liability, it gives support to the natural conclusion that transactions, which do not vary control or change the flow of economic benefits, are to be dismissed from consideration.

Nowhere in the *Higgins* case is there the slightest intimation that the Supreme Court intended to hold that transactions which *either* vary control or change the flow of economic benefits are not to be disregarded. On the other hand, the crux of the *Higgins* case is in the statement that (p. 477):

> The Government may look at actualities and upon determination that the form employed for doing business or carrying out the challenged tax event is unreal or a sham [i.e., without a business purpose] may sustain or disregard the effect of the fiction as best serves the tax statute.

The arrangement here did not achieve the business result claimed for it, namely, to increase the taxpayer's working capital, since the "capital" retained transitorily was immediately disbursed in the form of "rentals" and removed from the possibility of use in the business. And the arrangement was a tax avoidance device without business benefit (other than a tax saving) and without substance, not only because of the absence of business purpose but also because the sale-lease form effected no change in the taxpayer's effective ownership of and control over the equipment.

In any event, as to the so-called "change in the flow of economic benefits", the evidence discloses that in 1943, when the partnership was formed, R. H. Shaffer, the majority stockholder of taxpayer, was still receiving an annual salary of $12,000, despite his inactivity for two years (R. 120), whereas the other stockholders were active, and, in the words of taxpayer's witness, S. B. Stocking, "working night and day and Sunday" (R. 121). This condition, and the unfairness in compensation which it engendered, could well have accounted for the decision to divide the "rental" payments in a manner which recognized the value of the services rendered as well as the ownership of stock. Be that as it may, the issue here is whether the contested payments qualified under the applicable statute as ordinary and necessary business expenses. In determining such an issue, it is not material that the payments were shared by the stockholders of taxpayer equally or according to some other formula. But where the same people as the sole stockholders of a corporation deal with themselves as the sole members of a partnership, the fact that they agree to share their "take" from the corporation's income in proportions different from their holdings in the corporation does not create a "change in the flow of economic benefits" (Br. 21) which would require their transactions to be recognized for tax purposes. This must have been the conclusion reached by the Court of Appeals for the Fifth Circuit in the *Armston* case, *supra,* where the payments claimed to be "rentals" were made 100% to Mrs. Armston as lessor of the equipment, whereas her interest in the W. M. Armston Company (the lessee) was but 60%.[3]

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[3] The fact that the Armstons were husband and wife does not distinguish that case from the case at bar, since, as the Supreme Court said in *Commissioner* v. *Culbertson,* 337 U.S. 733, 746, the "* * * existence of the family relationship does not create a status which itself determines tax questions."

Certainly, *Brown* v. *Commissioner,* 180 F. 2d 926 (C.A. 3d), and *Skemp* v. *Commissioner,* 168 F. 2d 598 (C.A. 7th), do not support taxpayer's contention, as in both of those cases the controlling fact was that there was an arms-length transaction between the lessor and "a new independent owner" (*Brown* v. *Commissioner, supra,* p. 929) under which transaction the payments were required for the continued use and possession of the property, the seller having completely relinquished control.

In *Commissioner* v. *Greenspun,* 156 F. 2d 917 (C.A. 5th), upon which taxpayer relies (Br. 20) the court recognized that (p. 920):

> * * * while real transactions between a corporation and its sole stockholder may not for the reason alone that the stock is solely owned be disregarded for tax purposes, transactions to be effective for such purposes must have reality, that is must achieve some legitimate business result, must not be mere tax dodging devices without business benefits or substance.

That case, while concerned with the same principle of law which applies here, involved such different facts and circumstances that it cannot be regarded as dispositive of this case. The property there (steel cylinders) had been rented by the corporation from the time of its organization in 1911, until its dissolution in 1941.[4] In 1918, Greenspun acquired all of the cylinders and sold them to the corporation. In 1919, Greenspun became sole stockholder of the corporation, bought the cylinders back at the same price at which he had sold them in the previous year, and leased them to the corporation for the same rent it had been paying from 1911. In holding that the corporation could deduct as rent in the taxable years 1939-1940, such part of the amounts

[4] With the exception of about one year in 1918-1919.

paid as constituted a reasonable charge for the use of the cylinders, the court pointed out (p. 921) that the transfer made in 1919 had no tax consequences; that the lease arrangement in the tax year was the same as had been in existence since 1911; [5] that the unreality lay not in the corporation's lease of the cylinders, but in the 1918 transfer of title to it in the first place; that the transfer back to Greenspun in 1919 merely restored the *status quo;* and that no question had ever previously been raised by anyone that Greenspun (and later a trust created by him) was not the real owner of the cylinders. The court also pointed out that the unreality in attributing the ownership of the cylinders to the corporation was further emphasized by the fact that the Tax Court there had also treated other cylinders, never at any time owned even briefly by the corporation, as in reality the corporation's property, rather than the property of Greenspun who had purchased them from third persons and always thereafter owned them.

The case of *Twin Oaks Co.* v. *Commissioner,* 183 F. 2d 385 (C.A. 9th), is also vitally distinguishable from the instant case. There taxpayer corporation discontinued its business, and the business was thereafter conducted by a partnership composed of taxpayer's three stockholders (two men and the wife of one) plus another person (the other wife). The corporate entity was retained and the corporation, in consideration of the partnership assuming its accounts payable and giving to the corporation its promissory note, transferred to the partnership all of its assets except the premises on which the business had been and was thereafter to be conducted. The partnership leased that land from the corporation. Each of the four partners contributed additional capital to the partnership. The Commis-

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[5] Except for the one year 1918-1919.

sioner allocated all of the partnership income to the corporation and the Tax Court affirmed. This Court reversed, stating (p. 387) that the conversion from corporate to partnership operation was more than a mere change in form. Such a radical change is far different from the situation here prevailing.

Indeed, the cases relied upon by taxpayer serve merely to emphasize the fact that the tax recognition, to be accorded a sale and leaseback arrangement, must obviously depend in each case upon the facts of that case. The facts in this case require the conclusion that despite the transfer of title the sale-lease arrangement was without substance taxwise.

There remains only taxpayer's assignment No. 4 (Br. 11), that the Tax Court erred in finding as a fact that the cargoes handled by taxpayer, including supplies for the Alcan Highway and Lend-Lease cargo destined for Russia, were handled "under an arrangement with the named Governments, which was expected to and did continue for the duration of the war". (R. 173.) Since that finding was not essential to the Tax Court's decision that the payments are not deductible, there would seem to be little to be gained from a discussion of it. However, it is apparent from Mr. Kennell's testimony (R. 107) that the arrangement was expected to continue for the duration of the war, as long as the Russian supply line was left open, and that the supply line was actually left open for the entire length of the war.

Viewed in the light of the well-recognized principle that deductions are a matter of legislative grace, it is clear that taxpayer has failed to sustain its burden of proving that the "rental" payments were "both ordinary *and* necessary". *Illinois Agricultural Hold. Co.* v. *Commissioner,* 131 F. 2d 583, 585 (C.A. 7th).

CONCLUSION

The decision of the Tax Court is correct and should be affirmed.

Respectfully submitted,

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